

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

ANNUAL REPORT MAILING LABEL – MAKE CHANGES AS NECESSARY

E-04204A

UNS Electric, Inc.

Attn: Karen Kissinger – Vice President, Controller & Chief Compliance Officer

P.O. Box 711 Mail Stop OH120

Tucson, AZ 85702

RECEIVED

APR 15 2004

ARIZONA CORPORATION COMMISSION
DIRECTOR OF UTILITIES

ANNUAL REPORT

FOR YEAR ENDING

12	31	2003
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FOR COMMISSION USE

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PROCESSED BY

SCANNED

COMPANY INFORMATION

Company Name (Business Name) UNS Electric, Inc.

Mailing Address P.O. Box 711, Mail Stop OH-120

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

520-571-4000

Telephone No. (Include Area Code)

520-571-4160

Fax No. (Include Area Code)

N/A

Pager/Cell No. (Include Area Code)

Email Address jlebrecht@tep.com or kkissinger@tep.com

Local Office Mailing Address P.O. Box 711, Mail Stop OH-120

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

520-571-4000

Local Office Telephone No. (Include Area Code)

520-571-4160

Fax No. (Include Area Code)

N/A

Pager/Cell No. (Include Area Code)

Email Address jlebrecht@tep.com or kkissinger@tep.com

MANAGEMENT INFORMATION

Management Contact: David Couture

(Name)

Director of Regulatory Services

(Title)

3950 East Irvington Road, Mail Stop OH-122

(Street)

Tucson

(City)

Arizona

(State)

85714

(Zip)

520-745-3422

Telephone No. (Include Area Code)

520-571-4106

Fax No. (Include Area Code)

520-410-1795

Pager/Cell No. (Include Area Code)

Email Address dcouture@tep.com

On Site Manager:

Tom Ferry

(Name)

Vice President and General Manager

2498 Airway Ave.

(Street)

Kingman

(City)

Arizona

(State)

86402

(Zip)

520-681-8901

Telephone No. (Include Area Code)

520-681-8915

Fax No. (Include Area Code)

520-715-7234

Pager/Cell No. (Include Area Code)

Email Address tferry@uesaz.com

☒ Please mark this box if the above address(es) have changed or are updated since the last filing.

UNS Electric acquired assets from Citizens Communications on August 11, 2003. This report reflects changes in addresses from the reports previously filed by Citizens Communications.

Statutory Agent: Diana K. Durako

(Name)

One South Church Avenue, Suite 1820

(Street)

Tucson

(City)

Arizona

(State)

85701

(Zip)

520-571-4000 ext. 3652

Telephone No. (Include Area Code)

520-571-3612

Fax No. (Include Area Code)

N/A

Pager/Cell No. (Include Area Code)

Attorney: Vincent Nitido, Jr.

(Name)

P.O. Box 711

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

520-571-4000 ext. 3670

Telephone No. (Include Area Code)

520-571-3612

Fax No. (Include Area Code)

N/A

Pager/Cell No. (Include Area Code)

☒ Please mark this box if the above address(es) have changed or are updated since the last filing.

OWNERSHIP INFORMATION

Check the following box that applies to your company:

☐ Sole Proprietor (S)

☒ C Corporation (C) (Other than Association/Co-op)

☐ Partnership (P)

☐ Subchapter S Corporation (Z)

☐ Bankruptcy (B)

☐ Association/Co-op (A)

☐ Receivership (R)

☐ Limited Liability Company

☐ Other (Describe) _____

COUNTIES SERVED

Check the box below for the county/ies in which you are certificated to provide service:

☐ APACHE

☐ COCHISE

☐ COCONINO

☐ GILA

☐ GRAHAM

☐ GREENLEE

☐ LA PAZ

☐ MARICOPA

☒ MOHAVE

☐ NAVAJO

☐ PIMA

☐ PINAL

☒ SANTA CRUZ

☐ YAVAPAI

☐ YUMA

☐ STATEWIDE

SERVICES AUTHORIZED TO PROVIDE

Check the following box/es for the services that you are authorized to provide:

☒ **Electric**

- ☒ Investor Owned Electric
- ☐ Rural Electric Cooperative
- ☐ Utility Distribution Company
- ☐ Electric Service Provider
 - ☐ Transmission Service Provider
 - ☐ Meter Service Provider
 - ☐ Meter Reading Service Provider
 - ☐ Billing and Collection
 - ☐ Ancillary Services
 - ☐ Generation Provider
 - ☐ Aggregator/Broker

☐ **Telecommunications**

- ☐ Incumbent Local Exchange Carrier
- ☐ Interexchange Carrier
- ☐ Competitive Local Exchange Carrier
- ☐ Reseller
- ☐ Alternative Operator Service Provider

☐ **Gas**

- ☐ Natural Gas
- ☐ Propane

☐ **Other** (Specify) _____

STATISTICAL INFORMATION

TELECOMMUNICATION UTILITIES ONLY

Total residential access lines	_____
Total business access lines	_____
Total revenue from Arizona operations	\$ _____
Total income from Arizona operations	\$ _____
Value of assets used to serve Arizona customers	\$ _____
Accumulated depreciation associated with those assets	\$ _____

STATISTICAL INFORMATION (CONT'D)

ELECTRIC UTILITY PROVIDERS ONLY

Total number of customers (at 12/31/2003)	81,160	
Residential	68,861	
Commercial	9,873	
Industrial	11	
Public street and highway lighting	2,414	
Irrigation		
Resale	1	
 Total kilowatt-hours sold (1)	561,736,436	kWh
Residential	301,540,009	
Commercial	206,625,251	
Industrial	51,743,757	
Public street and highway lighting	951,548	
Irrigation		
Resale	875,871	
 Maximum Peak Load	340	MW

GAS UTILITIES ONLY

Total number of customers		
Residential		
Commercial		
Industrial		
Irrigation		
Public Authority		
 Total therms sold		therms
Residential		
Commercial		
Industrial		
Irrigation		
Public Authority		

(1) Statistics on this schedule reflect activity from the date of acquisition of assets from Citizens Communications (August 11, 2003) through December 31, 2003.

VERIFICATION
AND
SWORN STATEMENT
Intrastate Revenues Only

RECEIVED

APR 15 2004

VERIFICATION

STATE OF Arizona

I, THE UNDERSIGNED
OF THE

COUNTY OF (COUNTY NAME)	ARIZONA CORPORATION COMMISSION
Pima	DIRECTOR OF UTILITIES
NAME (OWNER OR OFFICIAL) TITLE	
Karen G. Kissinger, VP, Controller & CCO	
COMPANY NAME	
UNS Electric, Inc.	

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2003

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENT OF TITLE 40, ARTICLE 8, SECTION 40-401, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS DURING CALENDAR YEAR 2003 WAS:

Arizona Intrastate Gross Operating Revenues Only (\$)

\$ 59,699,993.21

(THE AMOUNT IN BOX ABOVE
INCLUDES \$ 4,625,392.88

IN SALES AND FRANCHISE TAXES BILLED, OR
COLLECTED)

**REVENUE REPORTED ON THIS PAGE MUST
INCLUDE SALES TAXES BILLED OR
COLLECTED. IF FOR ANY OTHER REASON,
THE REVENUE REPORTED ABOVE DOES NOT
AGREE WITH TOTAL OPERATING REVENUES
ELSEWHERE REPORTED, ATTACH THOSE
STATEMENTS THAT RECONCILE THE
DIFFERENCE. (EXPLAIN IN DETAIL)

Karen G. Kissinger
SIGNATURE OF OWNER OR OFFICIAL
745-3122
TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

OFFICIAL SEAL
A NOTARY PUBLIC IN AND FOR THE COUNTY OF
Notary Public, State of Arizona
PIMA
My Comm. Expires July 25, 2004
(SEAL)

DAY OF

COUNTY NAME	<u>Pima</u>
MONTH	<u>April</u> 20 <u>04</u>

Janet Anderson
SIGNATURE OF NOTARY PUBLIC

MY COMMISSION EXPIRES July 25, 2004

VERIFICATION
AND
SWORN STATEMENT
RESIDENTIAL REVENUE
INTRASTATE REVENUES ONLY

RECEIVED

APR 15 2004

STATE OF ARIZONA

I, THE UNDERSIGNED

OF THE

COUNTY OF (COUNTY NAME) Pima		ARIZONA CORPORATION COMMISSION DIRECTOR OF UTILITIES
NAME (OWNER OR OFFICIAL) Karen G. Kissinger	TITLE VP, Controller & CCO	
COMPANY NAME UNS Gas, Inc.		

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2003

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENTS OF TITLE 40, ARTICLE 8, SECTION 40-401.01, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS RECEIVED FROM RESIDENTIAL CUSTOMERS DURING CALENDAR YEAR 2003 WAS:

ARIZONA INTRASTATE GROSS OPERATING REVENUES

\$ 32,688,999.91

(THE AMOUNT IN BOX AT LEFT

INCLUDES \$ 2,515,422.70

IN SALES & FRANCHISE TAXES BILLED, OR COLLECTED

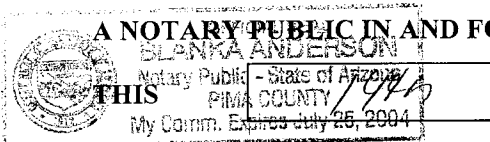
*RESIDENTIAL REVENUE REPORTED ON THIS PAGE
MUST INCLUDE SALES TAXES BILLED.

X Karen G. Kissinger
SIGNATURE OF OWNER OR OFFICIAL

745-3122
TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF



(SEAL)

DAY OF

NOTARY PUBLIC NAME <u>Blanka Anderson</u>	
COUNTY NAME <u>Pima</u>	
MONTH <u>April</u>	.20 <u>04</u>

MY COMMISSION EXPIRES

July 25, 2004

X

Blanka Anderson
SIGNATURE OF NOTARY PUBLIC

Report of Independent Auditors

To the Board of Directors and Stockholder of
UNS Electric, Inc.

In our opinion, the accompanying balance sheet and statement of capitalization and the related statements of income, stockholder's equity and cash flows present fairly, in all material respects, the financial position of UNS Electric, Inc. (the "Company") at December 31, 2003, and the results of its operations and its cash flows for the period April 14, 2003 (date of inception) to December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.



April 13, 2004

UNS ELECTRIC, INC.
STATEMENT OF INCOME
FOR THE PERIOD APRIL 14, 2003 (DATE OF INCEPTION) TO DECEMBER 31, 2003*

- Thousands of Dollars -

Operating Revenues	
Electric Retail Sales	\$ 55,075
Electric Wholesale Sales	81
Other Revenues	662
Total Operating Revenues	55,818
Operating Expenses	
Purchased Energy	37,013
Other Operations and Maintenance	8,575
Depreciation and Amortization	3,250
Taxes Other Than Income Taxes	2,198
Total Operating Expenses	51,036
Operating Income	4,782
Other Income (Deductions)	
Interest Income	157
Other Expense	(11)
Total Other Income (Deductions)	146
Interest Expense	
Long-Term Debt	1,804
Interest on Capital Leases	14
Other Interest Expense, Net of Amounts Capitalized	(111)
Total Interest Expense	1,707
Income Before Income Taxes	3,221
Income Taxes	1,272
Net Income	\$ 1,949

*Includes results of operations from the date of acquisition, August 11, 2003

See Notes to Financial Statements.

UNS ELECTRIC, INC.
STATEMENT OF CASH FLOWS
FOR THE PERIOD APRIL 14, 2003 (DATE OF INCEPTION) TO DECEMBER 31, 2003

- Thousands of Dollars -

Cash Flows from Operating Activities	
Cash Receipts from Electric Sales	\$ 61,074
Interest Received	23
Purchased Energy Costs Paid	(43,548)
Wages Paid, Net of Amounts Capitalized	(1,292)
Payment of Other Operations and Maintenance Costs	(5,060)
Taxes Paid, Net of Amounts Capitalized	(3,394)
Income Taxes Paid	(573)
Net Cash Flows - Operating Activities	7,230
Cash Flows from Investing Activities	
Capital Expenditures	(5,373)
Purchase of Citizens Assets	(83,766)
Other	(2)
Net Cash Flows - Investing Activities	(89,141)
Cash Flows from Financing Activities	
Proceeds from Issuance of Long-Term Debt	60,000
Unamortized Debt Expense	(410)
Equity Investment from UniSource Energy Services	33,734
Other	11
Net Cash Flows - Financing Activities	93,335
Net Increase in Cash and Cash Equivalents	11,424
Cash and Cash Equivalents, Beginning of Period	-
Cash and Cash Equivalents, End of Year	\$ 11,424

*Includes results of operations from the date of acquisition, August 11, 2003.

See Notes to Financial Statements.

UNS ELECTRIC, INC.
BALANCE SHEET

December 31,
2003

ASSETS		- Thousands of Dollars -
Utility Plant		
Plant in Service		\$ 82,240
Utility Plant under Capital Leases		706
Construction Work in Progress		13,677
Total Utility Plant		96,623
Less Accumulated Depreciation and Amortization		(3,506)
Less Accumulated Amortization of Capital Lease Assets		(36)
Total Utility Plant - Net		93,081
Current Assets		
Cash and Cash Equivalents		11,424
Trade Accounts Receivable, Less Allowance for Uncollectible Accounts of \$1		6,026
Unbilled Accounts Receivable		7,885
Receivable from Affiliates		127
Materials and Supplies		3,561
Deferred Income Taxes - Current		65
Other		254
Total Current Assets		29,342
Regulatory and Other Assets		
Deferred Income Taxes - Noncurrent		829
Other Assets		1,370
Total Regulatory and Other Assets		2,199
Total Assets		\$ 124,622
CAPITALIZATION AND OTHER LIABILITIES		
Capitalization		
Common Stock Equity		\$ 36,585
Capital Lease Obligations		606
Long-Term Debt		60,000
Total Capitalization		97,191
Current Liabilities		
Current Obligations under Capital Leases		76
Accounts Payable		8,850
Payable to Affiliates		2,440
Interest Accrued		1,794
Taxes Accrued		4,035
Accrued Employee Expenses		326
Other		4,827
Total Current Liabilities		22,348
Deferred Credits and Other Liabilities		
Regulatory Liabilities		1,667
Over Recovered Purchased Power Costs		466
Other		2,950
Total Deferred Credits and Other Liabilities		5,083
Commitments and Contingencies (Note 6)		
Total Capitalization and Other Liabilities		\$ 124,622

See Notes to Financial Statements.

UNS ELECTRIC, INC.
STATEMENT OF CAPITALIZATION

December 31,
2003

COMMON STOCK EQUITY		- Thousands of Dollars -
Common Stock--No Par Value		\$ 34,636
	2003	
Shares Authorized	1,000	
Shares Outstanding	1,000	
Accumulated Earnings		1,949
Total Common Stock Equity		36,585
CAPITAL LEASE OBLIGATIONS		
Total Capital Lease Obligations		682
Less Current Maturities		(76)
Total Long-Term Capital Lease Obligations		606
LONG-TERM DEBT		
Issue	Maturity	
Notes Payable	8/11/2008	60,000
Total Stated Principal Amount		60,000
Less Current Maturities		-
Total Long-Term Debt		60,000
Total Capitalization		\$ 97,191

See Notes to Financial Statements.

UNS ELECTRIC, INC.
STATEMENT OF CHANGES IN STOCKHOLDER'S EQUITY

	Common Shares Outstanding	Common Stock	Accumulated Earnings	Total Stockholders' Equity
- Thousands of Dollars -				
Balances at April 14, 2003 (Date of Inception)*	-	\$ -	\$ -	\$ -
1,000 Shares of Common Stock Issued	1,000	33,734	-	33,734
Noncash Equity Transactions	-	902	-	902
Comprehensive Income:				
2003 Net Income	-	-	1,949	1,949
Total Comprehensive Income				1,949
Balances at December 31, 2003	1,000	\$ 34,636	\$ 1,949	\$ 36,585

*Includes results of operations from the date of acquisition, August 11, 2003.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE 1. NATURE OF OPERATIONS

UNS Electric, Inc. (UNS Electric) procures, transmits and distributes electricity to 81,000 retail electric customers in the Mohave county of Northern Arizona and the Santa Cruz county of Southern Arizona. UniSource Energy Services, Inc. (UES), an intermediate holding company, established UNS Electric on April 14, 2003, and owns all of the common stock of UNS Electric and UNS Gas. UniSource Energy Corporation (UniSource Energy) owns all of the common stock of UES

On August 11, 2003, UNS Gas and UNS Electric completed the purchase of the Arizona gas and electric system assets from Citizens Communications Company (Citizens). The operating results of UNS Gas and UNS Electric have been included in UES' consolidated financial statements since the acquisition date.

The purchase price and the allocation of the assets acquired and the liabilities assumed based on their estimated fair market values as of the acquisition date are as follows for the electric system assets:

Purchase Price:	-Thousands of Dollars-
Cash Paid	\$ 82,765
Transaction Costs	1,950
Total Purchase Price	\$ 84,715
Allocation of Purchase Price:	-Thousands of Dollars-
Property, Plant & Equipment	\$ 90,815
Current Assets	17,952
Other Assets	580
Current Liabilities	(20,385)
Deferred Credits and Other Liabilities	(4,247)
Total Purchase Price	\$ 84,715

UniSource Energy paid \$1 million of transaction costs included above that were pushed down to UNS Electric, but are not reported on UNS Electric's Statement of Cash Flows.

References to "we" and "our" are to UNS Electric.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

Our accounting policies conform to accounting principles generally accepted in the United States of America (GAAP), including the accounting principles for rate-regulated enterprises.

ACCOUNTING FOR RATE REGULATION

The Arizona Corporation Commission (ACC) and the Federal Energy Regulatory Commission (FERC) regulate portions of UNS Electric's utility accounting practices and electric rates. The ACC has authority over certain rates charged to retail customers, the issuance of securities, and transactions with affiliated parties. The FERC regulates UNS Electric's rates for wholesale power sales and interstate transmission services.

UNS Electric generally uses the same accounting policies and practices used by unregulated companies for financial reporting under GAAP. However, sometimes these principles, such as the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 71,

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Accounting for the Effects of Certain Types of Regulation (FAS 71), require special accounting treatment for regulated companies to show the effect of regulation. For example, in setting UNS Electric's retail rates, the ACC may not allow UNS Electric to currently charge our customers to recover certain expenses, but instead may require that these expenses be charged to customers in the future. In this situation, FAS 71 requires that UNS Electric defer these items and show them as regulatory assets on the balance sheet until we are allowed to charge our customers. UNS Electric then amortizes these items as expense to the income statement as those charges are recovered from customers. Similarly, certain revenue items may be deferred as regulatory liabilities, which are also eventually amortized to the income statement as rates to customers are reduced.

The conditions a regulated company must satisfy to apply the accounting policies and practices of FAS 71 include:

- an independent regulator sets rates;
- the regulator sets the rates to recover specific costs of delivering service; and
- the service territory lacks competitive pressures to reduce rates below the rates set by the regulator.

FAS 71 may, at some future date, be discontinued due to changes in the regulatory and competitive environments. If UNS Electric stopped applying FAS 71 to its regulated operations, it would write off the related balances of its regulatory assets as an expense and would write off its regulatory liabilities as income on its income statement. UNS Electric's cash flows would not be affected if it stopped applying FAS 71 unless a regulatory order limited its ability to recover the cost of that regulatory asset. We believe our electric operations continue to meet the criteria for FAS 71.

UTILITY PLANT

UNS Electric reports its utility plant at cost. Utility plant includes material and labor costs, contractor costs, construction overhead costs, and an allowance for funds used during construction (AFUDC). We charge maintenance and repairs to operating expense as incurred.

AFUDC represents the estimated cost of debt and equity funds that finance utility plant construction. We recover AFUDC in rates through depreciation expense over the useful life of the related asset. For the period August 11, 2003 through December 31, 2003, UNS Electric imputed the cost of capital on construction expenditures at an average of 8.73%. The component of AFUDC attributable to borrowed funds is included as a reduction of Other Interest Expense on the income statement and totaled \$0.2 million in 2003. The equity component is included in Interest Income and totaled \$0.1 million in 2003.

We compute depreciation of utility plant on a straight-line basis over the service lives of the assets. The average annual depreciation rates for UNS Electric's utility plant for the period of August 11, 2003 through December 31, 2003 was 4.70%.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

MATERIALS AND SUPPLIES

UNS Electric carries transmission and distribution materials and supplies in inventory at the lower of cost or market.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

COMPUTER SOFTWARE COSTS

UNS Electric capitalizes all costs incurred to purchase computer software and amortizes those costs over the estimated economic life of the product. We would immediately expense capitalized computer software costs if the software were determined to be no longer useful.

DEBT

We defer costs related to the issuance of debt. These costs include underwriters' commissions, discounts or premiums, and other costs such as legal, accounting and regulatory fees and printing costs. We amortize these costs over the life of the debt using the straight-line method, which approximates the effective interest method. At December 31, 2003, unamortized debt issuance costs totaled \$0.4 million.

UTILITY OPERATING REVENUES

UNS Electric records revenues from customers when we provide services. Electric utility revenues are based on rates authorized by the ACC and include revenues applicable to energy consumed from meter reading dates to month end but not yet billed to the customers (unbilled revenues). Unbilled revenues are dependent upon a number of factors, including customer use and weather. Unbilled revenues are reversed the following month when actual billings occur. UNS Electric's Unbilled Accounts Receivable at December 31, 2003 totaled \$8 million. We record an allowance for our estimate of revenues billed for which collection is doubtful. UNS Electric's Allowance for Uncollectible Accounts was \$0.2 million at December 31, 2003.

Other Revenues primarily consists of miscellaneous fees, including service connect and late fees, and rental revenue from pole attachments.

PURCHASED ENERGY COSTS

UNS Electric defers differences between purchased energy costs and the recovery of such costs in revenues. UNS Electric adjusts future billings for such deferrals through the use of a Purchased Power and Fuel Adjustment Clause (PPFAC) approved by the ACC. The PPFAC allows for a revenue surcharge or surcredit (that adjusts the customer's base rate for delivered purchased power) to collect or return under or over recovery of costs.

AFFILIATED COMPANY TRANSACTIONS

UNS Electric receives certain corporate and administrative support services from affiliates. These costs, which totaled \$1.6 million from Tucson Electric Power Company (TEP) and \$21,734 from UNS Gas in 2003, consist primarily of employee compensation and benefits. TEP, a regulated public utility serving retail electric customers in Southern Arizona, is UniSource Energy's largest operating subsidiary.

INCOME TAXES

GAAP requires us to report some of our assets and liabilities differently in our financial statements than we do for income tax purposes. We report the tax effects of differences in these items as deferred income tax assets or liabilities in our balance sheet. We measure these tax assets and liabilities using current income tax rates.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

UNS Electric applies Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), as amended. Under FAS 133, all derivative instruments, except those meeting specific exceptions, are recognized in the balance sheet at their fair value. Changes in fair value are recognized immediately in earnings unless specific hedge accounting criteria are met.

Management has determined that UNS Electric's energy and capacity purchase commitments, in addition to the Company's contract with Pinnacle West Capital Corporation (PWCC), qualify under the scope exception provided for requirements contracts by FAS 133.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of our current assets and liabilities approximate fair value because of the short maturity of these instruments.

UNS Electric considers the principal amounts of the \$60 million of senior unsecured notes issued in August 2003 to be reasonable estimates of their fair value.

USE OF ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 3. REGULATORY MATTERS

Concurrent with the closing of the acquisition, retail rate increases for customers of UNS Electric went into effect on August 11, 2003. These rate increases were approved by the ACC on July 3, 2003, when it approved the acquisition and the terms of the April 1, 2003 settlement agreement (UES Settlement Agreement) among UniSource Energy, Citizens, and the ACC Staff.

The ACC order and UES Settlement Agreement include the following terms related to UNS Electric rates

- A 22% overall increase in retail rates effective August 11, 2003 from the rates previously in effect for Citizens. This reflects the implementation of a PPFA of \$0.01825 per kWh, which combined with the current base purchased power rate of \$0.05194 per kWh, results in a new PPFA rate of \$0.07019. This allows UNS Electric to fully recover the cost of purchased power under its current contract with its sole energy supplier, PWCC.
- UNS Electric must attempt to renegotiate the PWCC purchase power contract, and any savings that result from a renegotiated contract must be allocated in a ratio of 90% to ratepayers and 10% to shareholders.

The ACC order also requires that TEP submit in its next general rate case filing in June 2004, a feasibility study and consolidation plan, or a plan for coordination of operations of UNS Electric's operations in Santa Cruz County with those of TEP.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Under the terms of the ACC order, UNS Electric may not file a general rate increase until August 2006 and any resulting rate increase shall not become effective prior to August 1, 2007.

The UES Settlement Agreement also limits dividends payable by UNS Electric to UniSource Energy to 75% of earnings until the ratio of common equity to total capitalization reaches 40%. The ratio of common equity to total capitalization for UNS Electric was 38% at December 31, 2003.

On November 3, 2003, UNS Electric filed a plan to open its service territories to retail electric competition. The plan is subject to review and approval by the ACC. As a result of court decisions concerning the ACC's Retail Electric Competition Rules, we are unable to predict when and how the ACC will address this plan.

Regulatory Liabilities

At December 31, 2003, regulatory liabilities consist of the following:

	Regulatory Liabilities
	-Thousands of Dollars-
Regulatory Liabilities:	
Over Recovered Purchased Power Costs	\$ 466
Deferred Environmental Friendly Portfolio Surcharge	1,036
Net Cost of Removal for Interim Retirements	165
Regulatory Liabilities	\$ 1,667

Future Implications of Discontinuing Application of FAS 71

Based on the regulatory liability balances at December 31, 2003, if UNS Electric had stopped applying FAS 71 to its regulated operations, it would have recorded an extraordinary after-tax gain of \$1 million. UNS Electric's cash flows would not be affected if it stopped applying FAS 71 unless a regulatory order limited its ability to recover the cost of its regulatory assets.

NOTE 4. UTILITY PLANT AND CAPITAL LEASE OBLIGATIONS

The following table shows Utility Plant in Service and depreciable lives by major class at December 31, 2003:

	Plant in Service	Depreciable Lives
	-Thousands of Dollars-	
Electric Generation Plant	\$ 5,297	23 – 40 years
Electric Distribution Plant	60,451	14 – 26 years
Electric Transmission Plant	11,123	11 – 45 years
General Plant	3,388	7 – 33 years
Intangible Plant	1,981	5 – 25 years
Total Plant in Service	\$ 82,240	
Utility Plant under Capital Leases	\$ 706	

Intangible Plant primarily represents computer software costs.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

The following provides additional information on UNS Electric's capital lease obligations:

Capital Lease Obligations	
-Thousands of Dollars-	
2004	\$ 115
2005	115
2006	115
2007	115
2008	115
Total 2004-2008	575
Thereafter	269
Imputed Interest	(162)
Total	\$ 682

NOTE 5. LONG-TERM DEBT

On August 11, 2003, UNS Electric issued a total of \$60 million of aggregate principal amount of senior unsecured notes in a private placement. Proceeds from the note issuance were paid to Citizens to purchase the Arizona electric system assets. UNS Electric issued \$60 million of 7.61% notes due August 11, 2008. The notes may be prepaid with a make-whole call premium reflecting a discount rate equal to an equivalent maturity U.S. treasury security yield plus 50 basis points. UNS Electric incurred a total of \$0.4 million in debt costs related to the issuance of the notes. These costs were deferred and are being amortized over the life of the notes. UES guaranteed the notes.

The note purchase agreement contains certain restrictive covenants, including restrictions on transactions with affiliates, mergers, liens to secure indebtedness, restricted payments, incurrence of indebtedness, and minimum net worth. The actual and required minimum net worth levels at December 31, 2003 follow:

	Required Minimum Net Worth	Actual Net Worth
-Millions of Dollars-		
UES	\$ 50	\$ 90
UNS Electric	26	37

The incurrence of indebtedness covenant requires UNS Electric to meet certain tests before an additional dollar of indebtedness may be incurred. These tests include (a) a ratio of Consolidated Long-Term Debt to Consolidated Total Capitalization of no greater than 0.67 to 1.00 prior to September 30, 2004, and no greater than 0.65 to 1.00 after September 30, 2004, and (b) an Interest Coverage Ratio (a measure of cash flow to cover interest expense) of at least 2.50 to 1.00. However, UNS Electric may, without meeting these tests, refinance indebtedness and incur short-term debt in an amount not to exceed \$5 million. UNS Electric may not declare or make distributions or dividends (restricted payments) on their common stock unless (a) immediately after giving effect to such action no default or event of default would exist under such company's note purchase agreement and (b) immediately after giving effect to such action, such company would be permitted to incur an additional dollar of indebtedness under the debt incurrence test for such company. As of December 31, 2003, UNS Electric was in compliance with the terms of the note purchase agreement.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE 6. COMMITMENTS AND CONTINGENCIES

We record liabilities for loss contingencies, including environmental remediation costs, arising from claims, assessments, litigation, fines and penalties and other sources when it is probable that a liability has been incurred and the amount of the assessment can be reasonably estimated.

ENERGY AND TRANSPORTATION COMMITMENTS

UNS Electric has a full requirements power supply agreement with PWCC. The agreement expires May 31, 2008. The agreement obligates PWCC to supply all of UNS Electric's power requirements at a fixed price. Payments under the contract are usage based, with no fixed customer or demand charges. UNS Electric imports the power it purchases over the Western Area Power Administration's (WAPA) transmission lines. UNS Electric's transmission capacity agreements with WAPA provide for annual rate adjustments and expire in February 2008 and June 2011. The contract that expires in 2008 also contains a capacity adjustment clause.

UNS Electric made payments under these contracts of \$2 million in 2003. At December 31, 2003, UNS Electric estimates its future minimum payments under these contracts to be:

Purchase Obligations	
-Millions of Dollars-	
2004	\$ 6
2005	1
2006	1
2007	1
2008	1
Total 2004 - 2008	10
Thereafter	3
Total	\$ 13

OPERATING LEASES

UNS Electric has entered into operating leases, primarily for office facilities and office equipment, with varying terms, provisions, and expiration dates. UNS Electric's estimated future minimum payments under non-cancelable operating leases at December 31, 2003 follow:

Operating Leases	
-Thousands of Dollars-	
2004	\$ 420
2005	419
2006	410
2007	405
2008	405
Total 2004-2008	2,059
Thereafter	1,100
Total	\$ 3,159

UNS Electric's consolidated operating lease expense was \$0.2 million from April 14, 2003, the date of inception, to December 31, 2003.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

ENVIRONMENTAL CONTINGENCIES

UNS Electric owns and operates the Valencia Power Plant (Valencia), located in Nogales, Arizona. The Valencia plant consists of three gas and diesel-fueled combustion turbine units. UNS Electric will begin a project to decontaminate the soil at its Valencia facility in the coming year. We estimate the cost of decontamination to total at least \$0.6 million and accrued that amount as a liability in 2003. The ultimate cost, however, will depend on the extent of contamination found as the project progresses and when final remediation occurs. We expect decontamination to be substantially completed within five years. The purchase agreement with Citizens limits UNS Electric's obligation to \$1.5 million.

NOTE 7. ACCOUNTING FOR ASSET RETIREMENT OBLIGATIONS

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (FAS 143). It requires entities to record the fair value of a liability for a legal obligation to retire an asset in the period in which the liability is incurred. A legal obligation is a liability that a party is required to settle as a result of an existing or enacted law, statute, ordinance or contract. When the liability is initially recorded, the entity should capitalize a cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is adjusted to its present value by recognizing accretion expense as an operating expense in the income statement each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss if the actual costs differ from the recorded amount.

UNS Electric has various transmission and distribution lines that operate under land leases and rights of way that contain end dates and restorative clauses. UNS Electric operates its transmission and distribution systems as if they will be operated in perpetuity and would continue to be used or sold without land remediation. As a result, UNS Electric is not recognizing the costs of final removal of the transmission and distribution lines in its financial statements. As of December 31, 2003, UNS Electric had accrued \$0.2 million for the net cost of removal for interim retirements from its transmission, distribution and general plant. These amounts have been recorded as a regulatory liability.

Amounts recorded under FAS 143 are subject to various assumptions and determinations, such as determining whether a legal obligation exists to remove assets, estimating the fair value of the costs of removal, estimating when final removal will occur, and the credit-adjusted risk-free interest rates to be used to discount future liabilities. Changes that may arise over time with regard to these assumptions and determinations will change amounts recorded in the future as expense for asset retirement obligations.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE 8. INCOME TAXES

UniSource Energy includes UNS Electric's taxable income in its consolidated federal income tax return. Deferred tax assets (liabilities) as of December 31, 2003 consist of the following:

	Deferred Tax Assets/(Liabilities)
	-Thousands of Dollars-
Gross Deferred Income Tax Liabilities	
Plant	\$ (267)
Other	(19)
Gross Deferred Income Tax Liabilities	(286)
Gross Deferred Income Tax Assets	
Alternative Minimum Tax Credit (AMT)	573
Customer Advances	291
Contributions in Aid of Construction	69
Purchased Power and Fuel Adjustment Clause	184
Other	63
Gross Deferred Income Tax Assets	1,180
Net Deferred Income Tax Assets	\$ 894

We record deferred tax liabilities for amounts that will increase income taxes on future tax returns. We record deferred tax assets for amounts that could be used to reduce income taxes on future tax returns. UNS Electric has determined that a valuation allowance on the deferred income tax assets at December 31, 2003, is not necessary. We reached this conclusion based on our interpretation of tax rules, tax planning strategies, scheduled reversals of temporary differences, and projected future taxable income.

Income tax expense (benefit) included in the income statement includes amounts both payable currently and deferred for payment in future periods as indicated below:

	Income Tax Expense/(Benefit)
	-Thousands of Dollars-
Current Tax Expense/(Benefit)	
Federal	\$ 1,880
State	285
Deferred Tax Expense/(Benefit)	
Federal	(836)
State	(57)
Total Federal and State Income Tax Expense	\$ 1,272

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

The following reconciles the provision for income taxes at the federal statutory rate of 35% to the effective rate for the year ended December 31, 2003:

	Income Tax Expense/(Benefit)
	-Thousands of Dollars-
Federal Income Tax Expense at Statutory Rate	\$ 1,128
State Income Tax Expense, Net of Federal Deduction	148
Other	(4)
Total Federal and State Income Tax Expense	\$ 1,272

NOTE 9. PENSION AND POSTRETIREMENT BENEFIT PLANS

UNS Electric does not maintain a separate pension plan or other postretirement benefit plan for its employees. All regular employees are eligible to participate in the pension plan maintained by the company's parent, UES. A small group of active employees are also eligible to participate in a postretirement medical benefit plan. UES allocates net periodic benefit cost based on service cost for participating employees.

PENSION PLAN

UES established a noncontributory, defined benefit pension plan for substantially all regular employees on August 11, 2003. We base benefits on years of service and the employee's average compensation. UES has not yet funded the plan, but will contribute at least the minimum amount required under Internal Revenue Service regulations.

OTHER POSTRETIREMENT BENEFIT PLAN

UNS Electric assumed a \$1.3 million liability for postretirement medical benefits for current retirees and a small group of active employees at the acquisition of the Arizona electric system assets from Citizens. The select active employees participate in the TEP Postretirement Benefit Plan.

The ACC allows UNS Electric to recover postretirement costs through rates only as benefit payments are made to or on behalf of retirees. We fund postretirement benefits entirely on a pay-as-you-go basis. Under current accounting guidance, UNS Electric cannot record a regulatory asset for the excess of expense calculated per Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, over actual benefit payments.

The actuarial present values of the pension benefit obligations and other postretirement benefit plans were measured at December 1. UES' benefit obligation, plan assets, and funded status for both UNS Gas and UNS Electric at December 31, 2003 follow:

	Pension Benefits	Other Postretirement Benefits
	-Thousands of Dollars-	
Benefit Obligation at End of Year	\$ 3,787	\$ 1,690
Fair Value of Plan Assets at End of Year	-	-
Funded Status	\$(3,787)	\$(1,690)

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Amounts recognized in UNS Electric's Balance Sheet at December 31, 2003 include:

	Pension Benefits	Other Postretirement Benefits
	-Thousands of Dollars-	
Accrued Benefit Liability Included in Other Liabilities	\$ (576)	\$ (1,274)
Intangible Asset Included in Other Assets	378	-
Net Amount Recognized in the Balance Sheet	\$ (198)	\$ (1,274)

UNS Electric's net periodic benefit cost, employer contributions and benefits paid for the period August 11, 2003 to December 31, 2003 follow:

	Pension Benefits	Other Postretirement Benefits
	-Thousands of Dollars-	
Net Periodic Benefit Cost	\$ 198	\$ 26
Employer Contribution	-	27
Benefits Paid	-	27

Weighted-Average Assumptions Used to Determine Benefit Obligations as of December 1,	Pension Benefits	Other Postretirement Benefits
Discount Rate	6.25%	5.50%
Rate of Compensation Increase	3.75%	-

Weighted-Average Assumptions Used to Determine Net Periodic Benefit Costs for the Period Ended December 31,	Pension Benefits	Other Postretirement Benefits
Discount Rate	6.50%	5.25%
Rate of Compensation Increase	4.00%	-

For measurement purposes, a 15 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 2004. The rate was assumed to decrease gradually to 5 percent for 2013 and remain at that level thereafter.

Contributions

UNS Electric expects to contribute \$0.5 million to the pension plan in 2004.

DEFINED CONTRIBUTION PLANS

UES sponsors a defined contribution savings plan that is offered to all eligible employees. The plan is a qualified 401(k) plan under the Internal Revenue Code. In a defined contribution plan, the benefits a participant receives result from regular contributions to a participant account. Participants direct the investment of contributions to certain funds in their account. UES makes matching contributions to participant accounts under this plan. Matching contributions to this plan for UNS Electric's participating employees were \$41,000 in 2003.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE 11. SUPPLEMENTAL CASH FLOW INFORMATION

A reconciliation of net income to net cash flows from operating activities follows:

	Period April 14, 2003 (Date of Inception) to December 31, 2003
	-Thousands of Dollars-
Net Income	\$ 1,949
Adjustments to Reconcile Net Income to Net Cash Flows	
Depreciation and Amortization Expense	3,250
Amortization of Deferred Debt-Related Costs included in	
Interest Expense	24
Provision for Bad Debts	246
Deferred Income Taxes	700
Other	891
Changes in Assets and Liabilities which Provided (Used)	
Cash Exclusive of Changes Shown Separately	
Accounts Receivable	224
Materials and Supplies Inventory	(238)
Accounts Payable	(7,024)
Interest Accrued	1,676
Taxes Accrued	4,035
Other Current Assets	(6)
Other Current Liabilities	1,503
Net Cash Flows – Operating Activities	\$ 7,230

UES made non-cash equity contributions of \$1 million to UNS Electric that affected recognized assets and liabilities but did not result in cash receipts or payments.

On August 11, 2003, UniSource Energy acquired the Arizona gas and electric system assets from Citizens for \$223 million, comprised of the base purchase price plus other operating capital adjustments and transaction costs. In conjunction with the acquisition, liabilities were assumed as follows:

Purchase Price Allocation	
	- Thousands of Dollars -
Fair Value of Assets Acquired	\$ 109,347
Liabilities Assumed	24,632
Assets/Liabilities Purchased	\$ 84,715
Cash Paid for Citizens Assets	\$ 82,765
Transaction Costs	1,950
Total Purchase Price	\$ 84,715

UniSource Energy paid \$1 million of transaction costs included above that are not reported on UNS Electric's Statement of Cash Flows.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (CONCLUDED)

NOTE 12. PROPOSED ACQUISITION OF UNISOURCE ENERGY

At a special meeting held on March 29, 2004, UniSource Energy's shareholders voted to approve an acquisition agreement UniSource Energy entered into on November 21, 2003 with Saguaro Acquisition Corp., a wholly-owned indirect subsidiary of Saguaro Utility Group L.P. (Saguaro Utility), providing for the acquisition of all of the common stock of UniSource Energy for \$25.25 per share. The acquisition agreement provides that Saguaro Acquisition Corp. will merge with and into UniSource Energy, with UniSource Energy surviving the merger as a wholly-owned indirect subsidiary of Saguaro Utility. UniSource Energy expects the acquisition, which is subject to several conditions, including certain regulatory approvals, to occur in the second half of 2004.

The acquisition agreement contains operating covenants with respect to the operations of UniSource Energy's business pending the consummation of the acquisition. Generally, unless UniSource Energy obtains Saguaro Acquisition Corp.'s prior written consent, UniSource Energy must conduct business in the ordinary course consistent with past practice and use all commercially reasonable efforts to preserve substantially intact the present business organization and present regulatory, business and employee relationships. In addition, the acquisition agreement restricts certain activities, subject to the receipt of Saguaro Acquisition Corp.'s prior written consent, including the issuance or repurchase of capital stock, the amendment of organizational documents, acquisitions and dispositions of assets, capital expenditures, incurrence of indebtedness, modification of employee compensation and benefits, changes in accounting methods, discharge of liabilities, and matters relating to UniSource Energy's investment in Millennium Energy Holdings, Inc.

Either UniSource Energy or Saguaro Acquisition Corp. may terminate the acquisition agreement in certain circumstances, including if the acquisition is not consummated by March 31, 2005 or certain regulatory approvals are not obtained. In certain circumstances, upon the termination of the acquisition agreement, UniSource Energy would be required to pay Saguaro Acquisition Corp.'s expenses and a termination fee in an aggregate amount of up to \$25 million.